

POLICY OF MATERIALITY OF ERRORS IN COMPLIANCE ASSESSMENTS

Note: This policy is a component of the CAT KIT and will be included as an exhibit during the next update to the Kit.

"Materiality" as used in this document is different than, and distinct from, the word "materiality" as used in 19 U.S.C.1592.

The U.S. Customs Service, Office of Strategic Trade, Regulatory Audit Division, has established its policy for assessing the results of Compliance Assessments (CA) of importers and for reporting the materiality of discrepancies found in classification, quantity, transaction value, and conditional checks. The attached matrix provides an overview of the materiality policy for the tested areas. The policy is intended to accomplish three important goals:

Improve consistency in the compliance testing of importer transactions, evaluation of test results, and recommended corrective action.

Provide a "letter of the law" (LOL) compliance rate allowing comparison between CA and Compliance Measurement (CM) results for classification, quantity, and reported value.

Establish a uniform system of reporting compliance assessment results, which complies with Generally Accepted Government Auditing Standards.

BACKGROUND: In Fiscal Year 1996, Compliance Assessment (CA) teams, composed of members from several Customs disciplines and led by Regulatory auditors, began conducting CA's of major importers. The CA teams used statistical testing of transactions to determine if importers had internal control systems that produced accurate and complete Customs information. The CA teams computed a compliance rate for each of the "common check" trade areas, and also tested other "conditional check" trade areas, if they were relevant to the importer under review. The compliance rates measured the percentage of time sampled transactions were correct. If a compliance rate was below 95 percent in any trade area, the CA team determined the cause and effect of the non-compliance and recommended corrective action. The compliance rates are used by the CA team as a basis for its recommendation of a "compliance risk category" in the CA audit report.

Both CA teams and importers were concerned because some of the instances of non-compliance found during the assessments were minor discrepancies that resulted in low compliance rates but did not accurately reflect the importer's overall compliance with Customs regulations. There were also questions about how minor discrepancies should be addressed in the CA audit report. Since Customs must adhere to Generally Accepted Government Auditing Standards, any consideration of materiality of audit results or reporting had to comply with those standards.

To address these concerns, representatives from Customs Office of Strategic Trade, Office of Field Operations, and importers from several different industries, formed a joint task force to resolve differences on the issues and develop a policy on the materiality of audit findings. The following procedures are the result of the joint effort of Customs and trade representatives.

PROCEDURES: In accordance with Generally Accepted Government Auditing Standards, Customs will report all instances of non-compliance with laws and regulations to the auditee and will take materiality into consideration, thus providing perspective to the findings in the audit report.

A LOL compliance rate will be computed for classification, quantity, reported transaction value, record keeping, and certain "conditional check" trade areas (special trade programs and trade focus areas). If the LOL compliance rate is at least 95 percent and internal controls are documented, the CA audit report will recommend the company be considered low risk in the respective trade area. If the LOL compliance rate is at least 95 percent, but internal controls are not documented, the report will recommend the company be considered moderate risk in the respective trade area.

If the LOL compliance rate is below the acceptable rate of 95 percent in these areas, a materiality compliance rate will be computed. CA audit reports will include both LOL compliance rates and materiality compliance rates. The materiality compliance rate will be the basis for the compliance risk category recommended in the audit report.

DETAILS FOR EACH TRADE AREA

Classification

LOL Compliance Rate

The CA team import specialist reviews the classification of each item in the sample and compares it to the classification entered on the Customs Form (CF) 7501.

Any discrepancy between the tenth digit tariff number determined to be correct by the CA team import specialist and the tariff number entered on the CF 7501 is counted as an error.

Sample data is entered into an electronic sampling program which projects a statistically valid error rate (includes allowance for sampling error). The LOL compliance rate is 100 percent minus the projected error rate. The LOL compliance rate states the percentage of sampled items that are correctly classified to the tenth tariff digit.

If the LOL compliance rate is below 95 percent, a materiality compliance rate will be computed to put the significance of the errors in perspective.

Materiality Compliance Rate

The CA team import specialist determines, for each discrepancy, the tariff number digit where the classification error occurred. If the discrepancy occurred at the ninth or tenth digit, the CA team import specialist determines if the discrepancy resulted in a loss of revenue or affected admissibility.

Any discrepancies identified in digits one through eight of the entered tariff classification plus any discrepancies in the ninth or tenth digit that resulted in a loss of revenue or affected admissibility are counted as "material" errors.

The CA team enters only the "material" errors in the electronic sampling program to determine the projected materiality error rate (including sampling error). The materiality compliance rate is 100 percent minus the projected materiality error rate. The materiality compliance rate states the percentage of sampled items that were correctly classified to the eighth tariff digit and had no errors at the ninth or tenth digit that caused a loss of revenue or affected admissibility.

If the materiality compliance rate is 95 percent or above, no Compliance Improvement Plan (CIP) is required, just a recommendation that the importer strive to assure reported classifications are correct to the tenth tariff digit. If the materiality compliance rate is at least 95 percent and internal controls are documented, the CA audit report should recommend the company be considered low risk for classification non-compliance.

If the materiality compliance rate is at least 95 percent, but internal controls are not documented, the report should recommend the company be considered moderate risk for classification non-compliance.

If the materiality compliance rate in classification is below 95 percent, the company will be required to submit a CIP and the report will recommend the company receive the level of cargo examinations for high risk importers.

Quantity

LOL Compliance Rate

The CA team reviews the quantity recorded in company records (inventory, receiving, etc.) and compares that quantity to the number recorded on the CF 7501 and the invoice. In some cases, the tariff does not require a unit quantity on the CF 7501, so the quantity in company records should be compared to quantities on the commercial invoice instead.

Any discrepancy, either over or short, between the quantity entered in company records and the quantity on the CF 7501, or invoice, is counted as an error. In some instances, importers have documented agreements with the ports on how to handle small quantity differences identified after entry summary. The CA team should consider these agreements when deciding if a discrepancy is to be counted as an error.

Sample data is entered into an electronic sampling program which projects a statistically valid error rate (includes allowance for sampling error). The LOL compliance rate is 100 percent minus the projected error rate. The LOL compliance rate states the percentage of items tested that had accurate entered quantities. If the LOL compliance rate is below 95 percent, a materiality compliance rate will be computed to put the significance of the errors in perspective and determine the government risk and the associated level of cargo examinations to recommend in the audit report.

Materiality Compliance Rate

To put the errors in perspective, the dollar value of each error (based on discrepant units times the value per unit), both over- and under-declared, is added to determine the absolute total dollar value of the quantity errors. The total value of the discrepant quantities is divided by the total reported transaction value of the sample to compute the materiality error rate. For example, the total reported transaction value of the 100 sample line items is \$3 million.

There are 140 discrepant units valued at \$100 each (\$14,000). The materiality error rate is .47 percent ($\$14,000/3,000,000 = .47$ percent). The materiality compliance rate is 99.53 percent (100 percent - .47 percent = 99.53 percent). This method uses a simple ratio, with no sampling error added. The materiality compliance rate measures the value of the errors in relation to the total reported transaction value of the quantities tested.

Experience has shown that CA's completed on importers using reasonable care, the materiality compliance rate is at least 99.5 percent. Therefore, if the materiality compliance rate is 99.5 percent or above, no CIP is required, just a recommendation that the importer strive to assure accurate quantities are reported. If the materiality compliance rate is at least 99.5 percent, and internal controls are documented, the company should be considered low risk for non-compliance in entered quantities.

If the materiality compliance rate is at least 99.5 percent, but internal controls are not documented, the report should recommend the company be considered moderate risk for non-compliance in entered quantities.

If the materiality compliance rate in quantity is below 99.5 percent, the company will be required to submit a CIP and the report will recommend the company receive the level of cargo examinations for high risk importers.

Reported Transaction Value

LOL Compliance Rate

The CA team reviews the reported transaction value recorded in company records (payments, purchases, etc.) and compares that reported transaction value to the amount recorded in the CF 7501.

Any discrepancy, either over- or under-declared, between the reported transaction value entered in company records and the value reported on the CF 7501, is counted as an error. As in the case of quantity, importers may have documented agreements with the ports on how to handle small value differences found after filing the entry summary. The CA team should consider these agreements when deciding if a discrepancy is to be counted as an error.

Sample data is entered into an electronic sampling program which projects a statistically valid error rate (includes allowance for sampling error). The LOL compliance rate is 100 percent minus the projected error rate. The rate measures the percentage of the items tested that had accurate entered reported transaction values.

If the LOL compliance rate is below 95 percent, a materiality compliance rate will be computed to put the significance of the errors in perspective and determine the government risk and the associated level of cargo examinations to recommend in the CA audit report.

Materiality Compliance Rate

To put the errors in perspective, the reported transaction value of each discrepancy, both over- and under-declared, is added to determine the absolute value of the discrepancies. The value of the discrepancies is divided by the total value of the sample to compute the materiality error rate. This method uses a simple ratio, with no sampling error added.

The materiality compliance rate measures the value of the errors in relation to the total value tested.

For example, the total value of the 100 sample items in the sample is \$5 million. Discrepancies in value total \$33,000. The materiality error rate is .66 percent ($\$33,000/\$5,000,000 = .66$ percent). The materiality compliance rate is 99.34 percent ($100 \text{ percent} - .66 \text{ percent} = 99.34 \text{ percent}$).

If the materiality compliance rate is 99.5 percent or above, and internal controls are good, the company should be considered low risk for non-compliance in reporting accurate transaction value. No CIP is required, just a recommendation that the importer strive to assure accurate transaction values are reported.

If the materiality compliance rate is at least 99.5 percent, but internal controls are not documented, the report should recommend the company be considered moderate risk for non-compliance in entered value.

If the materiality compliance rate in reported transaction value is below 99.5 percent, the company should be required to submit a CIP and the report should recommend the company receive the level of cargo examinations for high risk importers.

Unreported Transaction Value

There are no compliance rates computed for unreported transaction value, either LOL or materiality. The risk level for the importer is determined based on the \$100,000 threshold stated in the audit program. If unreported transaction value equal to or more than \$100,000 is found during any part of the CA (including projected amounts), the company should be required to submit a CIP and the report should recommend the company receive the level of cargo examinations for high risk importers.

If less than \$100,000 in unreported transaction value is found during any part of the CA, and if the company's has documented internal control procedures for this area, the company should be considered low risk for the trade area. If less than \$100,000 in unreported transaction value is found, but the company does not have documented internal control procedures, the company should be considered moderate risk for the trade area.

Computed Value

A materiality compliance rate is not computed for this area. The importer's risk level is based on the LOL compliance rate as this rate already takes into account the dollar value of errors. The LOL rate for computed value equals the value or duty difference (error) per audit of the cost submission, divided by the total value or duty reported by the company in the cost submission.

Recordkeeping

No materiality compliance rate will be computed for recordkeeping because materiality is considered in the selection of records or data to test.

Conditional Checks

Materiality Compliance Rate

With the exception of transshipment, the computation of materiality compliance rates for conditional check areas follows the same guideline as quantity and reported transaction value - i.e. the total absolute value of the errors is divided by the total value of the sample to compute the materiality error rate. The materiality compliance rate is 100 percent minus the materiality error rate.

The value of an individual error may be the total value of the sample item (e.g., if requirements for special treatment are not met) or part of the value of the sample item (e.g., if the incorrect value was claimed for special treatment). As an illustration, the value of an error in review of HTSUS 9802.00.80 would be the total reported value of the sample item if foreign fabrication was required before assembly (i.e. HTSUS 9802.00.80 treatment requirements were not met). However, the value of an error in the same review would be only part of the reported value of the sample item if one component of the imported article (made up of several components) was determined to be of foreign origin. In this case, the value of the error would be only the value of the foreign component (not the total reported value of the sample item).

If the materiality compliance rate is 99.5 percent or above, no CIP is required, just a recommendation that the importer strive to assure accurate reporting. If the materiality compliance rate is at least 99.5 percent, and internal controls are documented, the company should be considered low risk for non-compliance. If the materiality compliance rate is at least 99.5 percent, but internal controls are not documented, the report should recommend the company be considered moderate risk for non-compliance.

If the materiality compliance rate is below 99.5 percent, the company will be required to submit a CIP and the report will recommend the company receive the level of cargo examinations for high-risk importers.

For transshipment, compliance rates (LOL and materiality) are not computed. If errors are identified in tests for Transshipment, further action will depend on the individual circumstances (refer to the Technical Guide).

EFFECTIVE DATE: This policy is effective for all compliance Assessments in process as of or started after January 1, 1999.

POINT OF CONTACT: Any questions relating to this policy may be directed to Carrolyn McDaniel at (206) 553-1336 or to Thomas Jesukiewicz at (562) 980-3220.

SUMMARY OF MATERIALITY STANDARDS

Area	If "Letter of the Law" Rate is	Then	If "Materiality Rate" is	Then
Quantity	≥95%	Passes Test Area		
	<95%	Calculate materiality rate	≥99.5%	Passes Test Area
			<99.5%	Fails Test Area Needs CIP
Reported Transaction Value	≥95%	Passes Test Area		
	<95%	Calculate materiality rate	≥99.5%	Passes Test Area
			<99.5%	Fails Test Area Needs CIP
Unreported Transaction Value			<\$100,000	Passes Test Area
			≥\$100,000	Fails Test Area Needs CIP
Classifi- cation	≥95%	Passes Test Area		
	<95%	Calculate materiality rate	≥95%	Passes Test Area
			<95%	Fails Test Area Needs CIP
Record- keeping	≥95%	Passes Test Area		
	<95%	Fails Test Area Needs CIP		
Conditional Checks	≥95%	Passes Test Area		
	<95%	Calculate materiality rate	≥99.5%	Passes Test Area
			<99.5%	Fails Test Area Needs CIP